

# Breaks it

## Economist Insights

Those campaigning for the UK to leave the EU often focus on immigration, arguing that it could be reduced after Brexit. Yet economists know that higher immigration is good for growth and so do markets. Their disquiet is evident. Sterling has nosedived as the markets wrestle with the uncertain consequences of Brexit, both for the UK's economic growth and its trading prospects. Whatever the ultimate consequences, Brexit creates uncertainty and markets do not like uncertainty.



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Many people are worried about foreign machines coming into the UK and taking up all the positions in UK factories. Free movement of capital means that machines from anywhere in the EU can be brought into the UK, where they use up British electricity. When the machines break they are a drain on UK engineering services. Leaving the EU would allow the UK to stop this unwanted machine migration.

If this sounds like nonsense to you, then you are right. Who would worry about importing machines from Europe to UK factories? There is no fixed amount of machines that the UK can have: more machinery increases the productive capacity of the economy, allowing the UK to produce more and grow richer. Even if the machines break down occasionally they more than pay for themselves.

Yet these arguments, with the same logic, are applied to economic migrants. There is no fixed number of jobs that the UK can have: more workers means more productive capacity. This is so obviously true: if you had decided in 1960 that there was a 'fixed' number of jobs, then everyone who joined the labour force since then would be unemployed. But history shows us that increasing population is associated with increasing growth. And plenty of studies show that immigrants contribute more tax than they use up in public services.

Relying on this 'lump sum of labor' fallacy to guide economic policy is a recipe for slower growth. So to economists, concerns about the economic impacts of immigration are overblown, and sometimes simply a disguise for the angst some feel about social change. But in a macro perspective, immigration is quite simply positive for growth.

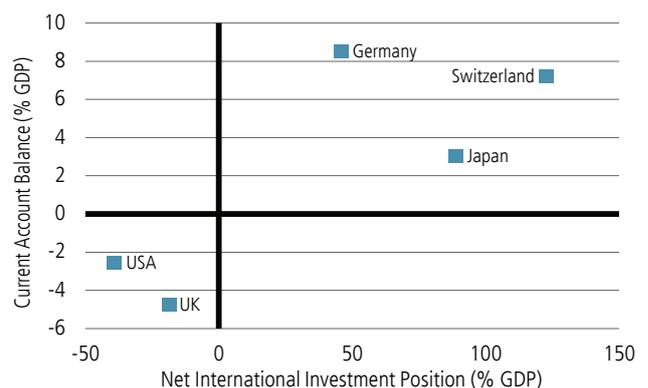
Just like economists, the markets understand this point, and have not reacted well to a perceived increase in the risk of a UK exit from the Eurozone, or Brexit. Sterling has taken a

nosedive, suggesting investors are less willing to keep money in the UK. And this is at a time when markets are jittery, when normally they would want to put their money into a safe haven like the UK.

What do markets look for in a 'safe haven'? Liquidity is important, and on that score the UK looks fine. Strong external finances are another important factor, but here the UK looks decidedly fragile. Most safe haven countries have a solid current account surplus (so they spend less than they earn) and a strong net international investment position (they own more foreign assets than foreigners own of their assets). The two exceptions are the US and UK (chart 1). But the US has the exorbitant privilege of being the issuer of the global reserve currency. The UK has no such privilege.

**Chart 1: Not any port in a storm**

International investment position and current account balance of 'safe haven' countries, as share of GDP 2015



Source: IMF, national statistical agencies

But this is not a new problem. Why should Brexit risk make currency markets suddenly take notice of these imbalances? Perhaps because the markets suspect that Brexit threatens the other two features of a safe haven: a stable political system and steady economic growth.

A decision to leave the EU would create huge political uncertainty in the UK. What would be the nature of the new relationship with Europe? Would the UK be able to retain its influence in the wider world? There is also the wild card of Scotland demanding another independence referendum after a vote to exit (one the Scottish Nationalists would be far more likely to win). Not to mention that losing the Brexit vote would probably spell the political end of Prime Minister David Cameron, possibly allowing the Tory party to shift to the right – so that UK politics on both sides would be more extreme.

The challenge to growth comes from various channels. One would be the restrictions on new machines - sorry, immigrants - entering the UK. Economic growth is a function of land, labor and capital; reduce the labor and you reduce growth. Just think: the US economy would never have become the largest in the world, or even existed in its current form, without massive immigration.

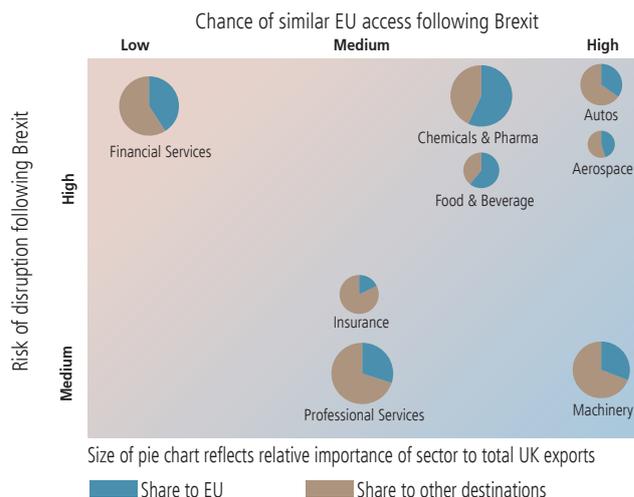
The second important channel is, of course, trade. All of the EU has benefited from the single market: it is not a question of whether a country has a surplus or deficit at any one time (that has more to do with how spendthrift or miserly a country is). The real benefits come from exploiting comparative advantage (encouraging specialisation in areas of relative competitiveness) and through increased competitive pressures. And the UK has been adept at taking advantage of such comparative advantages. True, the manufacturing sector has suffered (although not just in the UK) but the UK has been the European leader in providing services such as finance, legal and insurance.

The cost to the UK depends on the nature of the exit. But the greater the amount of access that the UK wants to the EU single market, the more of the rules and regulations the UK will be forced to adopt. If the UK gained high access by becoming a member of the European Economic Area, all Brexit would achieve is to remove the UK's ability to influence the trade rules. If the UK wants to avoid the EU rules then the UK would suffer from lower trade.

For some sectors standards are relatively international, so the in/out question matters less. Research by Open Europe has identified those sectors that are exposed to trade with the EU and the probability that they could retain similar access to the EU. Sectors such as autos and machinery should be fine. But it is the service sector where the UK would have difficulty retaining access, most especially in financial services. The impact on this key UK export could be severe indeed, and is perhaps subject to the greatest uncertainty.

**Chart 2: Separation anxiety**

Estimates of potential impact of Brexit on key UK export sectors, based on surveys conducted by Open Europe



Source: Open Europe, "The impact of Brexit on the UK's key export sectors"

Some have argued that the benefits of rolling back EU regulation would be huge, but we are doubtful of this. Are employees in the UK suddenly going to vote for politicians to remove rights that they have grown used to? Will people who had grown used to a clean environment suddenly support the idea that firms can pollute more? Certainly you can quote the cost of regulations, but regulations are decided on by comparing costs against benefits.

The key point about all this is the uncertainty. Markets are uncertain about the potential impacts, and markets do not like uncertainty. And it is not just markets; businesses do not like to invest in new equipment or hire new employees if there is heightened uncertainty about the future. As long as Brexit looks like a distinct possibility, the market will price in the possibility that Brexit for the UK economy could break it.

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